No. 10188

In the United States Circuit Court of Appeals

For the Ninth Circuit

American Surety Company, a Corporation, and
E. L. McDougal, *Appellants,*

vs.

The Bank of California, National Association,
a Corporation, *Appellee.*

Appellants' Reply Brief

Upon Appeal from the District Court of the United States
for the District of Oregon

Honorable James Alger Fee, District Judge

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AMERICAN SURETY COMPANY, a Corporation, and
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THE BANK OF CALIFORNIA, NATIONAL ASSOCIATION,
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Appellants' Reply Brief

Upon Appeal from the District Court of the United States
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HONORABLE JAMES ALGER FEE, District Judge

At the outset of its argument appellee recognizes the "familiar rule" of the liability of a bank to its depositor and then attempts to distinguish this case as being not an ordinary case to which the rule applies (Appellee's Brief, p. 9). This case is just as "ordinary" a case as the following leading cases:

Shipman et al vs. Bank of State of New York, 126 N. Y. 318, 27 N. E. 371.

Jordan Marsh Co. vs. Natl. Shawmut Bank, 201 Mass. 408, 87 N. E. 740.

Board of Education vs. National Union Bank, 16 N. J. M. 50, 196 A. 352, Aff'd. 121 N.J.L. 177, 1 A. (2d) 383.

United States C. S. Co. vs. Central Mfg. Dist. Bank, 343 Ill. 503, 175 N. E. 825.

Los Angeles Invest. Co. vs. Home Savings Bank, 180 Cal. 601, 182 P. 293.

Detroit P. R. Co. vs. Wayne County H. Sav. Bank, 252 Mich. 163, 233 N. W. 185.

American Sash & Door Co. vs. Commerce Trust Co., 232 Mo. 98, 56 S. W. (2d) 1034.

National Surety Co. vs. President & Directors of Manhattan Co., 252 N. Y. 247, 119 N. E. 372.

John G. Patton Co. vs. Guaranty Trust Co., 238 N. Y. S. 362, 227 A. D. 545, Aff'd. 254 N. Y. S. 621, 173 N. E. 893,

all cited and discussed in the first part of Appellants' Brief, pp. 16-41. And it is also as "ordinary" a case as those cited at page 43 of Appellants' Brief under "Subrogation."

All these cases involved fact situations similar to those in the instant case, cases in which many checks were involved, extending over a period of time and wherein the acts of the employee could have been discovered *had the employer assumed that the employee was dishonest and based upon such assumption made a check up of his acts.* Because we desired to present the issues involved squarely to this Court, appellants limited themselves to cases with similar facts and we urge this Court to examine the complete opinions of each of said cases.

In contending that the instant case is an "unusual" case appellee is attempting to confuse the legal issues involved. Throughout appellee's brief counsel employ this device quoting excerpts from cases involving entirely dif-

ferent fact situations—cases not involving a drawer—drawee relationship—injecting a misapplied theory of election of remedies and citing *Kaszab vs. Greenbaum Bank & T. Co.*, 252 Ill. App. 107 (Appellee's Brief, p. 37), which was overruled by the later case of the *United States C. S. Co. vs. Central Mfg. District Bank,* supra, decided by the Supreme Court of Illinois.

Beginning at the bottom of page 9 and extending to page 11, appellee makes an "unusual" argument. It recognizes the rule of liability at p. 10, contended for by appellants and then states that in view of such rule of law, the bank is not permitted to charge the depositors' account and the depositor's money is still in the bank. Therefore it concludes the depositor has suffered no loss. Appellee reaches this conclusion in its brief but in the operation of its bank it did not so conclude when it charged its depositor's account with the amount of these checks. Its act in so doing, even though wrongful, constituted a loss to the depositor. *It has the depositor's money as the result of the application of the legal rules of liability which appellants claim are applicable* (see Appellants' Brief, pp. 16-41) and not because of its voluntary admission that it has.

A more legalistic argument or rather legalistic riddle to offer a court of equity looking to the substance of the transactions involved is hard to imagine. It is akin to the stock metaphysical argument introduced to freshman college students on the non-existence of physical objects.

The adoption of appellee's contention would eliminate subrogation in every case of a payment by an insurer to an insured. It is not the law, as shown by the many cases cited in Appellant's Brief which permitted the insurer to recover (Appellants' Brief, p. 43) and that it is not the law in Oregon is clear from the Oregon Supreme Court's decision in *United States Fidelity Co. vs. United States National Bank,* 80 Or. 361, 157 P. 155.

Appellee is engaging in a play of words in this argument and in its contention that these are "loss" policies and not "liability" policies. We refer this Court to the case of *Grubnau vs. Centennial Natl. Bank,* 124 A. 142, 279 Pa. 501 (cited in Appellants' Brief at p. 43 and p. 58) and to our argument in Appellants' Brief, pp. 58, 59.

Beginning at page 11 and extending to page 19, appellee deals with election of remedies. Here again counsel for appellee is using legalistic reasoning to confuse the Court as to the issues in this case and citing cases and quoting legal principles which have no application to the instant case.

Election of remedies does not deal with a choice of recovery by an insured from its insurance company as against a recovery from a third party responsible to it for the loss by operation of legal rules of liability, but deals with a choice by such person of its legal remedies as between two or more parties legally liable to it for the loss by the operation of legal rules of liability. The remedies involved in such situations arise because of transactions of the parties which gives rise to the loss.

As pointed out at page 66 of Appellants' Brief, "If the acceptance by an insured of payment of a loss payable to it by an insurance company constituted an election of remedies, there never could be a case whereby an insurance company was subrogated to the rights of its insured." (See also quotation from *Chicago etc. R. Co. vs. Pullman,* 139 U. S. 79, 11 S. C. 490, 35 L. Ed., quoted by the Supreme Court of Oregon in *American Central Insurance Co. vs. Weller,* 106 Or. 494, 212 P. 803, set forth in Appellants' Brief at p. 66.)

Furthermore, as pointed out in Appellants' Brief, pages 58 and 59, such a view would cause insurance companies to compel an insured to first proceed against the third party and then pay the insured only after it has failed to recover from the third party. The courts have progressed, see *Grubnau vs. Centennial Natl. Bank,* supra, and permit the insurance companies to pay their insured directly and acquire the insured's rights by subrogation.

On page 18 counsel for appellee suggest that "Appellants could have made payment to Interior Warehouse Company in this case by means of a loan receipt and thereafter suit could have been brought in the name of the depositor."

Is such a practice to be encouraged by courts? Should insurance companies and their insureds be compelled and encouraged to play a game of make-believe? The Honorable Trial Court's decision will force them to (see Appellants' Brief, pp. 58 and 59), and counsel for appellee

themselves suggest it. Is it not better to recognize the realities of the situation as did the Supreme Court of Pennsylvania in *Grubnau vs. Centennial Natl. Bank,* supra, and the courts in the other cases cited in Appellants' Brief?

Counsel then quote (Appellee's Brief, p. 10) from 9 C.J.S. 752 a statement which does deal with an election of remedies. But note that the text is dealing with the choice of the depositor to recover from the drawee bank as against a person who indorsed the check subsequent to the forged indorsement. The right to recover arises from operation of legal rules of liability springing from the relationship of the parties as a result of dealing with the forged checks. The text in no way attempts to nullify or remove from an insurance company which in no way came into a legal relationship with the depositor by reason of any transactions with the forged checks, the right of subrogation.

With reference to the cases cited by appellee in this portion of the argument, it is to be observed that neither the Interior Warehouse Company, the named insured, nor the appellant insurance companies, sued or attempted to collect the loss from Crowe or any of the indorsers on the checks, all of whom, according to appellee, were also liable to the insured. *As between those parties and the appellee bank,* the depositor had an election of remedies and not having exercised an election, its insurance companies who were subrogated to its rights upon their payment of the loss acquired its rights against appellee. (See

cases Appellants' Brief, p. 43, *United States Fidelity Co. vs. United States Natl. Bank,* supra, 80 Or. 361, 157 P. 155.)

That this entire argument on election of remedies is purely legalistic and a play upon words rather than the application of sound legal principles which should govern the rights of the parties is tacitly admitted and disclosed in the following statement by counsel at page 17 of the brief:

> ". . . If the sureties intended to look to the bank and felt the bonded depositor had not been guilty of negligence in relation to the employee and the supervision of the bank account and returned vouchers permitting a recovery against the bank, *they were obligated to refuse payment* and advise the depositor that in fact and law it had suffered no loss and had no claim." (Emphasis ours.)

It is submitted that the law does not require an insurance company to first refuse payment and compel its assured to seek recovery from a third party and it is also submitted that this should not become the law by the application of a legalistic and misapplied argument of the principle of election of remedies.

At page 18 counsel state that "Subrogation certainly cannot place the sureties in the shoes of the depositor as of a date prior to the election, but after and subject to

the incidents of an election." Here again confusion of the issues is sought. *No election was made by the depositor* and appellee is attempting to make the payment which gave rise to the right of subrogation an act of election to then contend that an election occurred prior to the subrogation. Such a theory, if applied, would destroy the principle of subrogation; the act giving it birth would also be its death.

The closing sentence in counsel's argument (Appellee's Brief, p. 19) that "The sureties could also have sued for a declaratory judgment" also shows the weakness of the whole argument of appellee and its failure to squarely meet the issues. No need existed for invoking a declaratory judgment proceeding. The correct and direct proceeding was instituted by an action against the bank, and the bank in turn should have invoked the procedure provided by Rule 14 (a) of the Rules of Civil Procedure, bringing in the third parties liable over to it. Such procedure appellee purposely declined to follow, no doubt for business reasons, because it would involve its customers and sister banks, and such procedure counsel for appellee ignore in Appellee's Brief. Instead of facing and recognizing a procedure specifically provided for a situation as presented by the instant case, appellee ignored same and now suggests a declaratory judgment proceeding. Such suggestion by eminent counsel for appellee bears out the charge heretofore made that throughout their brief counsel seek to confuse the clear cut issues which are present and which determine the case.

In answer to appellee's argument (Appellee's Brief, pp. 19 and 20) that the Court below distinguished the Oregon case of *United States Fidelity Co. vs. United States National Bank,* 80 Or. 361, 157 P. 155, and applied the law of the later case of *American Central Insurance Co. vs. Weller,* 106 Or. 494, 212 P. 803, we urge this Court to reread our comment on pages 60, 62-67 of Appellants' Brief, and also to examine those cases. The *Weller* case in no way overrules the *United States Fidelity Co.* case and the latter case by its citation and quotation from the United States Supreme Court case of *Chicago, etc. R. Co. vs. Pullman,* 139 U. S. 79, 11 S. C. 490, 35 L. Ed. 97, recognizes the law as contended for by appellants.

Appellee's argument then proceeds with cases in which a defaulting official obtained a bond and the surety was denied subrogation. To bring itself within the rule of these cases, counsel state that Crowe was the principal on the bonds in question. We submit he was not, but that the policies were insurance policies issued to the Interior Warehouse Company. The company and not Crowe paid the premiums and the company was an insured rather than Crowe being a principal. The policies were for the benefit of Interior Warehouse Company and no one else. Furthermore, as pointed out in Appellants' Brief (pp. 46-56) some confusion does exist in the decisions of the courts in not clearly recognizing the basis of the law denying recovery to a surety of a governmental official and applying it indiscriminately. The Oregon Supreme

Court, however, did evidently recognize this distinction in *United States Fidelity Co. vs. United States National Bank,* supra, when it allowed the surety on the bond of a guardian to recover from the bank and it is this law of Oregon that must be applied to the instant case.

Appellee's Brief then continues (pp. 26-32) with the argument based upon the principle that where the equities are equal, or where the defendant's equities are superior, no recovery can be had by subrogation. In support of same, cases are cited which do not deal with facts like those in instant case involving a drawee-drawer relationship.

The case of *Meyers vs. Bank of America,* 11 Cal. (2d) 92, 77 P. (2d) 1084, which involved the forgery of checks payable to the *plaintiff* is discussed in Appellants' Brief commencing at page 52.

The case of *Jones vs. Bank of America* (Cal. App. 1942), 121 P. (2d) 94, 99, also did not deal with a drawee-drawer relationship and the court specifically holds and points out that a drawee bank is not liable to a payee of a check whose indorsement is forged because there is no privity between the bank and the payee of the check. The court does recognize, however, that a drawee bank is in privity with the drawer and it is responsible to the drawer, its depositor. The court likewise distinguishes such a case from a case between a drawee bank and a collecting bank citing *George vs. Security Trust & Savings Bank,* 91 Cal. App. 708, 267 P. 560.

State Bank vs. Billstrom (Minn. 1941), 299 N. W. 199, also cited as following the Meyers case, likewise involved a different fact situation and is a clear case of a bond of an official which bond is for the benefit of everyone, the court saying at page 201:

> "The official bond of Billstrom is for the benefit of any one injured by his delinquency. Mason Minn. St. 1927, Sec. 9698."

The case of *National Surety Corp. vs. Edwards House Co.* (Miss. 1941), 4 So. (2d) 340, cited as following the Meyers case likewise involved the bond of a governmental official and was not against a drawer bank which breached its contract with its depositor.

The facts in the case of *New York Title & Mortgage Co. vs. First Natl. Bank* (C.C.A. 8th), 51 F. (2d) 485, are entirely different from those present in the instant case as will be apparent to the Court from a mere reading of the opinion. The plaintiff in that case was insuring against defects in titles. Certificates of titles were forged, as well as checks. The court clarifies the opinion and shows it has no application to the instant case, at p. 487:

> ". . . The plaintiff here did not insure against the forgery of indorsements on these checks, but its contract was confined to the titles of the purported borrowers."

The case of *Washington Mechanics' Savings Bank vs. District Title Ins. Co.* (Ct. Appeals D. C.), 65 F. (2d) 827, was an action by the drawer against the collecting bank (Appellee's Brief, p. 31). The court injects into the law the concept of "culpable" negligence, which as shown in Appellants' Brief, p. 50, in the quotation from the Martin case (*Martin et al vs. Federal Surety Co.* (C.C.A. 8th), 58 F. (2d) 79) has been erroneously injected into the question of the right to subrogation. In the quotation set out in Appellee's Brief at page 31, the court states that the collecting bank accepted a check "whose genuineness it had no reason to doubt." The drawee bank, however, is duty bound to its depositor—an absolute duty—to know that the indorsements are genuine and accepts the checks at its own peril. Hence, there are no questions of equities in its favor when it breaches its contract.

American Bonding Co. vs. First National Bank, 27 Ky. L. 393, 85 S. W. 190, involved raised checks and did not involve a drawee bank which is in privity with and is duty bound to its depositor as is appellee in this case.

Appellee admits the rule of law as to the drawee bank's liability to its depositor. Having breached its contract, it is a wrongdoer, regardless of good faith, and cannot claim superior equities. *United States Fidelity Co. vs. United States Natl. Bank,* supra.

The next point urged in Appellee's Brief (pp. 39-40) to defeat appellants' recovery is the negligence of the Interior Warehouse Company in failing to discover the

dishonest acts of Crowe. Appellee's statement of the case (from p. 4 to p. 6) lays emphasis on matters which show *now* how the defalcations could have been discovered. From this it is pointed out that if certain things were done the forgeries could have been discovered. Interior Warehouse Company proceeded upon the assumption that its employee was honest. Acting upon such assumption is wrong according to appellee.

Appellee's statement of the case and the conclusion it draws therefrom is that an employer should not assume its trusted bookkeeper is honest, but should assume he is dishonest and in assuming that Crowe was honest, appellants were negligent. Under appellee's reasoning and analysis, a reasonably prudent employer should assume its bookkeeper to be dishonest and upon such assumption should proceed to supervise and check his conduct in minute detail.

Is it negligence on the part of an employer to assume an employee is honest? Is it negligence on the part of an employer to trust an employee? Although appellee's statement of the case is an argument that it should be, neither business practice nor the courts condemn employers, as do counsel for appellee, for their failure to assume that their employees are dishonest. See quotation from *Los Angeles Invest. Co. vs. Home Sav. Bank,* supra (180 Cal. 601, 182 P. 293), at page 39 of Appellants' Brief.

At page 33 of Appellee's Brief it is stated that on a number of checks Crowe, after forging the payee's name

indorsed his own. This occurred on only nine checks out of the total of 107 and not more than 2 of which were in the same month (Tr., pp. 46-58).

In our opening brief, beginning on page 28, and through page 41, we discuss fully the law with reference to the question of the depositor's negligence. The following cases, many of which have already been cited, support our position, first, that the Interior Warehouse Company was not negligent, and second, that its failure to discover the forgeries did not relieve the bank:

Shipman vs. Bank of State of New York, 126 N. Y. 318, 27 N. E. 371.

United States Cold Storage Co. vs. Central Mfg. Dist. Bank, 343 Ill. 503, 175 N. E. 825, 74 A.L.R. 811.

American Sash & Door Co. vs. Commerce Trust Co., 56 S. W. (2d) 1034 (Mo.) (See Note in 103 A.L.R. 1152).

Detroit Piston Ring Co. vs. Wayne County, etc., 252 Mich. 163, 233 N. W. 185, 75 A.L.R. 1273.

R. E. Land, Title & Trust Co. vs. United Sec. etc., 303 Pa. 273, 154 A. 593.

Board of Education vs. Natl. Union Bank, 196 A. 352 (Aff'd) 1 A. (2d) 383 (N. J.).

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Jordan Marsh Co. vs. Nat'l. Shawmut Bank, 201 Mass. 397, 87 N. E. 740, Note 74 A.L.R. 827.

Natl. Surety Co. vs. Natl. City Bank, 172 N.Y.S. 413, Note in 74 A.L.R. at 828.

Natl. Surety Co. vs. President & Directors of Manhattan Co. et al., 252 N. Y. 247, 169 N. E. 372, 67 A.L.R. 1113.

Natl. Metropolitan Bank vs. Realty & Title Co., 47 F. (2d) 982.

City of N. Y. vs. Bronx County Trust Co., 184 N. E. 495, 261 N. Y. 64.

John G. Patton Co. vs. Guaranty Trust Co. of N. Y., 238 N.Y.S.362, aff'd. 254 N.Y.621, 173 N.E.893.

All of these cases deal with the question of the depositor's negligence and the duty it owes the bank with reference to examining the bank statements. The facts in the instant case are similar to the facts in said cases and under the law of said cases, the Interior Warehouse Company was not guilty of negligence *such as to relieve the defendant of liability.* Furthermore, as pointed out by the courts in several of said cases, *negligence of the depositor to defeat recovery from the bank must be the "proximate cause"* and *in view of the fact that the bank in accepting the checks through the clearing house relied upon the indorsements of the collecting banks, the failure of the depositor to discover fraudulent acts was not the proximate cause.* The decision of the various courts discuss these points so clearly that we urge this Court to read these opinions rather than be burdened with further discussion by appellants' counsel.

Appellee cites the following four cases:

Defiance Lumber Co. vs. Bank of California, 180 Wash. 533, 41 Pac. (2d) 135.

C. E. Erickson vs. Iowa Natl. Bank, 211 Ia. 495, 230 N. W. 342.

Young vs. Gretna Trust & Savings Bank, 184 La. 872, 168 So. 85.

Kaszab vs. Greenebaum Sons Bk. & T. Co., 252 Ill. App. 107.

The last cited case decided by an intermediate appellate court of Illinois cannot be viewed as an authority in view of the later case of *United States C. S. Co. vs. Central Mfg. Dist. Bank,* supra, decided by the Supreme Court of Illinois which leaves no doubt as to appellants' right to recover.

The Washington case of *Defiance Lumber Co. vs. Bank of California,* supra, was decided by a divided court 5 to 4. The majority opinion ignores all the leading cases cited above which are called to the reader's attention by the dissenting opinion. The dissenting opinion ably shows that "the negligence of the drawer is immaterial unless it proximately affects the conduct of the bank in the performance of its duties," citing among other cases the *American Sash & Door Co. vs. Commerce Trust Co.,* supra, *Shipman vs. Bank of State of N. Y.,* supra, and *United States C. S. Co. vs. Central Mfg. Dist. Bank,* supra. The majority opinion also relies upon the "imposter" rule which clearly does not apply.

The case of *C. E. Erickson Co. vs. Iowa Natl. Bank,* supra, is ably answered by the Supreme Court of Missouri in the case of *American Sash & Door Co. vs. Commerce Trust Co.* (cited above), 56 S. W. (2d) 1034, at page 1039, wherein that court reviews all the decisions including those cited by appellee.

The result in the case of *Young vs. Gretna Trust & Savings Bank,* supra, is reached by the Louisiana court following the other three cases cited by appellee, one of which has since been overruled.

The case of *Royal Indemnity Co. vs. Federal Reserve Bank* (D. C. Ohio 1939), 119 F. (2d) 778, affirmed on District Judge's opinion, 38 F. Supp. 621, relied upon by appellee, did not involve an action between the drawer and the drawee bank, but an action by the drawer against a bank guaranteeing prior indorsers.

The case of *Mattison-Greenlee Service Corp. vs. Culhane,* 20 F. Supp. 882, the next case cited in Appellee's Brief, involved an entirely different fact situation and different rules of law than those governing the facts in the instant case which are clearly governed by the well established legal principles laid down in the cases heretofore cited and called to this Court's attention.

The case of *England National Bank vs. U. S.,* 282 F. 121, deals with an alteration on the face of the checks. The names of the payees in the check were erased and new names were inserted. The duty of the drawer to discover alterations on the face of checks returned to him

with the monthly statement is different from his duty to check indorsements and this difference is noted in all the cases heretofore cited by appellants dealing with the merits of this case.

Appellee raises the question of the missing originals of nineteen checks and cites Section 69-605, O.C.L.A., which is part of the Negotiable Instruments Act. This statute as well as Sections 69-603 and 69-604, O.C.L.A., all deal with the question of presentment and have no application to the instant case. Here again counsel for appellee are injecting a legal principle clearly inapplicable and merely to cause confusion of the clear cut issues.

This is an action for the breach of a bank's contract with its depositor by violating its contractual duty and not an action based upon a negotiable instrument in circulation. Appellants are not suing appellee for its failure to pay checks presented to it for payment and which appellee has declined to pay. The sections of the act cited presupposes valid instruments the holders of which are entitled to payment when the same are tendered. The instruments in question were forged and therefore void and invalid. Appellants are not presenting any checks to the appellee for payment but are demanding that appellee pay them for the amount of checks which it wrongfully charged to its depositor's account.

In closing, we cite to this Court the case of *United States vs. Natl. Bank of Commerce* (C.C.A. 9th), 205 F. 433, a decision by Judges Gilbert, Morrow and Wolverton, that it was not necessary for the depositor to tender the

checks involved as a necessary preliminary to the commencement of the action. The appellee in the instant case, as the defendant did in that case, made an absolute and unconditional refusal to pay.

We also cite this case for many of the propositions and contentions heretofore made in this brief because the court dealt with many of the same problems. This case also shows that appellee bank, as we have pointed out above, is not in the class of innocent third parties with superior equities so as to defeat appellants' right to be subrogated. At p. 438 the court makes the following statement which applies to appellee bank in the instant case:

> "It was their duty to ascertain whether there was such a person as the payee named in the checks, and to know that the person who presented the checks was entitled to receive the payment thereof. They made no investigation, required no identification, and took no precaution. *They paid the money negligently, and at their own risk, and the defendant bank in choosing to rely upon the identification of the payee by the banks which cashed the checks did so at its own risk.*" (Emphasis ours.)

This, we reiterate, was the cause of the loss, not the original dishonest acts of Crowe, because had this duty owing to a depositor been performed, no payment would have been made on these checks.

CONCLUSION

With reference to the appellee's liability, appellants have presented this Court with all the available authority on the subject, and under the authorities of the cases cited, involving similar fact situations, or by original application of recognized principles of contract and banking law, the appellee is liable for the breach of its contract with its depositor. The appellants being in the position of the depositor by subrogation, are entitled to recover the amount paid out by the appellee on these checks bearing forged indorsements.

Respectfully submitted,

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